KLEINWORT HAMBROS

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Inflation: new year, old problem

As 2022 begins, we face a long-dormant foe: high inflation. While growth in developed economies remains robust, inflation has increased by around 5% this year in the UK and the eurozone and by nearly 7% in the US, the highest rate since 1982. As Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, explains, the biggest risk for markets in 2022 is how aggressively central banks – particularly the US Federal Reserve (Fed) – act to tame inflation.

Although Fed tapering of quantitative easing and raising rates is largely priced into market prices, measures to shrink its balance sheet are not.

In a best-case scenario, liquidity remains ample and economic momentum is strong enough to withstand slightly higher rates. Moreover, central banks can run down their balance sheets slowly by not buying new bonds while holding the bonds they already own until maturity. Eventually, they resume normal open market operations, reducing their balance sheets by selling more bonds back to the market than they buy. If done when economic growth is strong enough, the likely result is a reduction in debt without destabilising markets.

In a worst-case scenario, liquidity dries up, economic momentum falters and central banks go too fast from "run off" to "sell off", as the European Central Bank did in 2013 and 2014. This would probably prompt an adverse reaction from markets, with declines and high volatility.

We believe the actual path will be closer to the former than the latter, allowing central banks to tighten policy slowly. Why? Mainly because the current high levels of inflation are being driven by temporary factors.

One, most of today's apparent surge is due to the base effect. In January 2021, the price of a barrel of Brent Crude oil was close to $50, compared with $80 now. This has been the single largest factor behind the rise in inflation. Few expect oil prices to soar again (though admittedly it's possible).

Two, there have been marked shifts in our consumption patterns. At its peak, post pandemic consumption of durable goods was 34% higher in real terms than before, as spending on services has been slashed. This overwhelmed supply chains and drove up the prices of many weighty components in inflation indices, such as used cars. Now, consumption patterns appear to be moving back towards normal, and supply chain blockages are easing.

Finally, perhaps the single most important indicator that inflation may become entrenched is spiralling wage growth. This forces companies to raise prices, thus leading workers to demand higher wages, a vicious cycle which will be familiar to anyone who lived through the 1970s. In the first quarter of 2021, the OECD's measure of gross pay and social security per employee reached 5.0%, worryingly high by past standards. However, it eased to 4.5% and 4.4% in quarters two and three and is likely to have peaked as pandemic era benefits dry up and COVID restrictions abate.

The bottom line

We believe the case for taking increased risks in investment portfolios is supported by the robust economic backdrop, strong momentum and still tolerable valuations of riskier assets. However, we are cognisant of the remaining downside risks, including the possibility that inflation surprises us by remaining stubbornly high. As a result, the portfolios we manage for clients continue to hold a stable of safe-haven assets including cash, government bonds, gold and defensive alternatives.

Contact us

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